Social Security

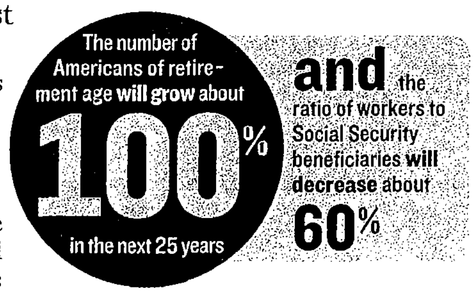
A Daring Leap

President Bush makes his proposed private accounts sound like the opportunity of a lifetime. But the fine print shows they pose great risk for you—and the nation.

BY ALLAN SLOAN

YOU'VE GOT TO GIVE PRESIDENT BUSH AN A-PLUS for the way he marketed the Social Security proposals in his State of the Union address last week. "If you've got children in their 20s, as some of us do, the idea of Social Security collapsing before they retire does not seem like a small matter," he said—a sentiment with which even a skeptic like me, who has twenty- and thirtysomething kids, totally agrees. "We must ensure that lower-income Americans get the help they need to have dignity and peace of mind in their retirement," he added. Then, with a twinkle in his eye, he talked about making Social Security "a better deal" for younger workers—a clever allusion to the New Deal of Franklin Delano Roosevelt, father of Social Security. You could almost feel the Democrats gnashing their teeth.

You can't argue with Bush's stated goals of making Social Security financially sound to allow Americans a secure retirement. "I will listen to anyone who has a good idea to offer," he said. But the conditions he laid down in the rest of the speech—demanding private accounts and no new payroll taxes—indicate that his mind's pretty much closed. For obvious reasons, he quickly skimmed over the sacrifices required to make any new system work, attributing the ideas to Democrats, such as former senator John Breaux. But in fact, so many details of Bush's plan have emerged that we can use some back-of-the-envelope math to see if they make sense. The short answer is that many of them don't—and I'll show you why. Don't worry, my envelope's bipartisan: there's plenty the



Democrats aren't telling you, either. Bush is pretending Social Security's about to collapse and go broke, which isn't true. The Dems are telling you that it can continue as is for more than 30 years without a problem—and that's not true, either.

Yes, I know that by now, you're loaded to the eyeballs with Social Security analyses. You've seen so many numbers your teeth hurt and your brain has reached statistical overload. Please bear with me. Based on my decade of deep-diving into Social Security's workings, I'll filter out the political junk, spare you all but the essential numbers and stick to economics.

Let me start by saying it would be great if Bush's (seriously flawed) proposals lead to a reasonable compromise to adapt Social Security to the 21st century. Bush would be a statesman for the ages. Hey, I don't have a knee-jerk bias against private Social Security accounts. I'm all in favor of them, properly structured. But Bush's aren't.

Now to the details. The Bush proposals are based on something called Plan 2 that was proffered as a solution to Social Security's woes by a commission Bush set up in 2001. A Wednesday press briefing by Chuck Blahous, the White House's Social Security point man who was executive director of the commission, makes it clear the Bushies are proposing Plan 2, with a few modifications.

The current system is clearly unsustainable, despite what Democrats say about it being sound until the 2040s. Today's workers support current Social Security retirees, and the next generation is supposed to support them. The ratio of workers to recipients has fallen from 16-1 to the current 3-1, and will fall to a future 2-1. Keeping the current system afloat would require some combination of cutbacks in future benefits, more money from workers or taxpayers, or both. Given that Bush doesn't want to increase taxes, all that's left—if he prevails—is benefit cutbacks. And Plan 2 has serious cutbacks. An average worker retiring in 2075, for instance, would get a benefit 46 percent below the current formula. Later cuts would be even deeper. The plan does this by using a benefit formula based on inflation rather than on wages, which are roughly 1 percent a year higher. A few decades of compounding 1 percents sure adds up.

The one tax on income that Bush hasn't cut as president is the Social Security wage tax, which costs 80 percent of American

PHOTO ILLUSTRATIONS BY MICHAEL ELINS FOR NEWSWEEK
CROWD PHOTO BY GETTY IMAGES

workers more than federal income tax does. By keeping the tax the same and reducing future benefits, Bush is like a candymaker that cuts 46 percent off a chocolate bar but charges the same 75 cents for it. In other words, his plan would effectively increase the Social Security tax. Sure, the current formula's unsustainable—but, as we'll see, there are other ways to fix things.

NOW, WATCH THIS. BUSH'S private accounts don't make Social Security financially sound—the benefit cuts do. The private accounts are something Bush insists on, not something Social Security needs to regain its long-term financial footing.

Shifting to private accounts, under Bush's plan, would lead to massive borrowing by the federal government, adding to our already huge deficits. Under the current system, your Social Security taxes go to pay Ma and Pa and Grandma and Grandpa, plus disabled people and survivors. If your money is going into a private account instead, how will Uncle Sam pay Ma and Pa? The same way Bush has paid for everything, be it tax cuts, wars or his Medicare prescription-drug benefit: borrowing.

In the first 10 years of private accounts, according to the Center on Budget and Policy Priorities, a Washington think tank, the government would have to borrow $1.3 trillion (including interest) to make up for wage taxes no longer available to pay Social Security benefits. (This assumes two thirds of eligible workers opt for the accounts.) Over the first 20 years, borrowings would total $4.5 trillion. This is serious jack. The Bushies like to compare these borrowings with what they claim is a $10.4 trillion gap between Social Security's obligations and the resources available to pay them. But the shortfall—let's not quibble about its size—would be eliminated by cutting the benefit formula. We'd be borrowing trillions to cover bets in the stock and bond markets for a system with "security" in its name. Given that foreigners are financing almost all our budget deficit, we'd be hocking ourselves even more to lenders—such as the central banks of Japan and China—whose long-term interests may not be the same as ours. I think that would be a terribly serious mistake for us to make.

This brings us to the Democrats, who keep clinging to the idea that Social Security's accumulated surpluses—known as the "trust fund"—will protect benefits under the current system until 2042. Plenty of people share that opinion. But they're wrong. Let me show you why, unless we change things, Social Security will become an incredible cash drain on the rest of the government a decade or two down the road. My analysis, incidentally, is the same as Chuck Blahous's—and we've arrived at it totally independently.

Look at the chart on page 42. You see that Social Security is now taking in more cash than it spends. The accumulated surplus is approaching $2 trillion. But there's a big problem here, fans. The money isn't being saved. Instead, one part of the government, the Treasury, is writing IOUs to another part, Social Security. The Treasury borrows Social Security's surplus cash and gives it IOUs in return. It pays interest on the trust fund's IOUs with additional IOUs rather than cash. So you've got a big pile of government promises to itself. Nothing's been saved. It's as if you wrote IOUs to yourself, stuck them in a coffee can and

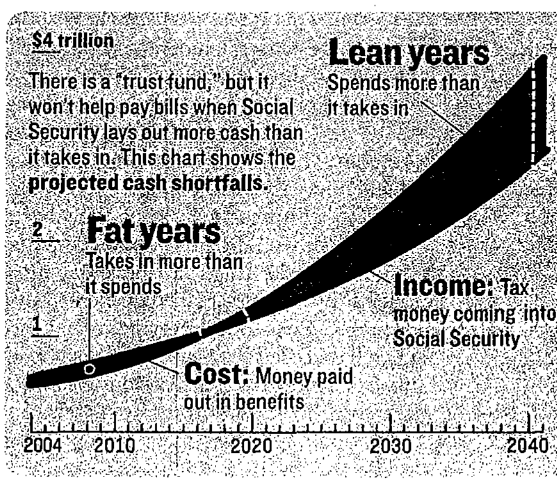
Snapshot Of Social Security

69% of Social Security beneficiaries are **retired workers** (DEC. 2004)

17% are **disabled workers**

14% are **survivors** of deceased workers

Social Security is the **only source of income** for **22%** of older Americans



2041 The year Social Security takes in **$1 trillion** less than it pays out.

2018 **Benefits will exceed** Social Security's income from taxes, and the system will need cash to plug the gap.

66% of older Americans get **50% or more** of their income from Social Security

The average monthly Social Security benefit is **$872** (DEC. 2004)

The Bush Plan

Investment: Workers 54 and younger will be able to divert up to 4% of their wages, not exceeding $1,000 at first, to invest in a selection of stock and bond funds (i.e., private accounts).

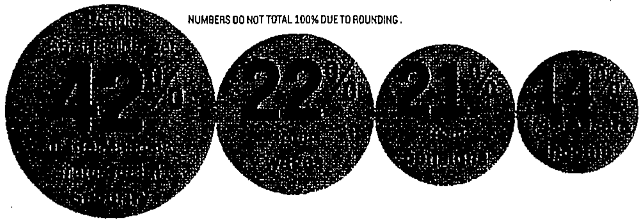
Benefits: A new formula cuts most workers' guaranteed retirement benefits, which the government then reduces even further to offset money going into their private accounts.

Markets: If accounts earn more than 3% above inflation, workers would come out ahead on their private accounts—but they'd be worse off if accounts earn less than that.

Retirement: Only when they stop working can people access their private accounts. The government will require most retirees to use the accounts to buy annuities, producing lifetime income that rises with inflation.

REPORTED BY JOSH ULICK. GRAPHICS BY KARL GUDE—NEWSWEEK

NUMBERS DO NOT TOTAL 100% DUE TO ROUNDING.



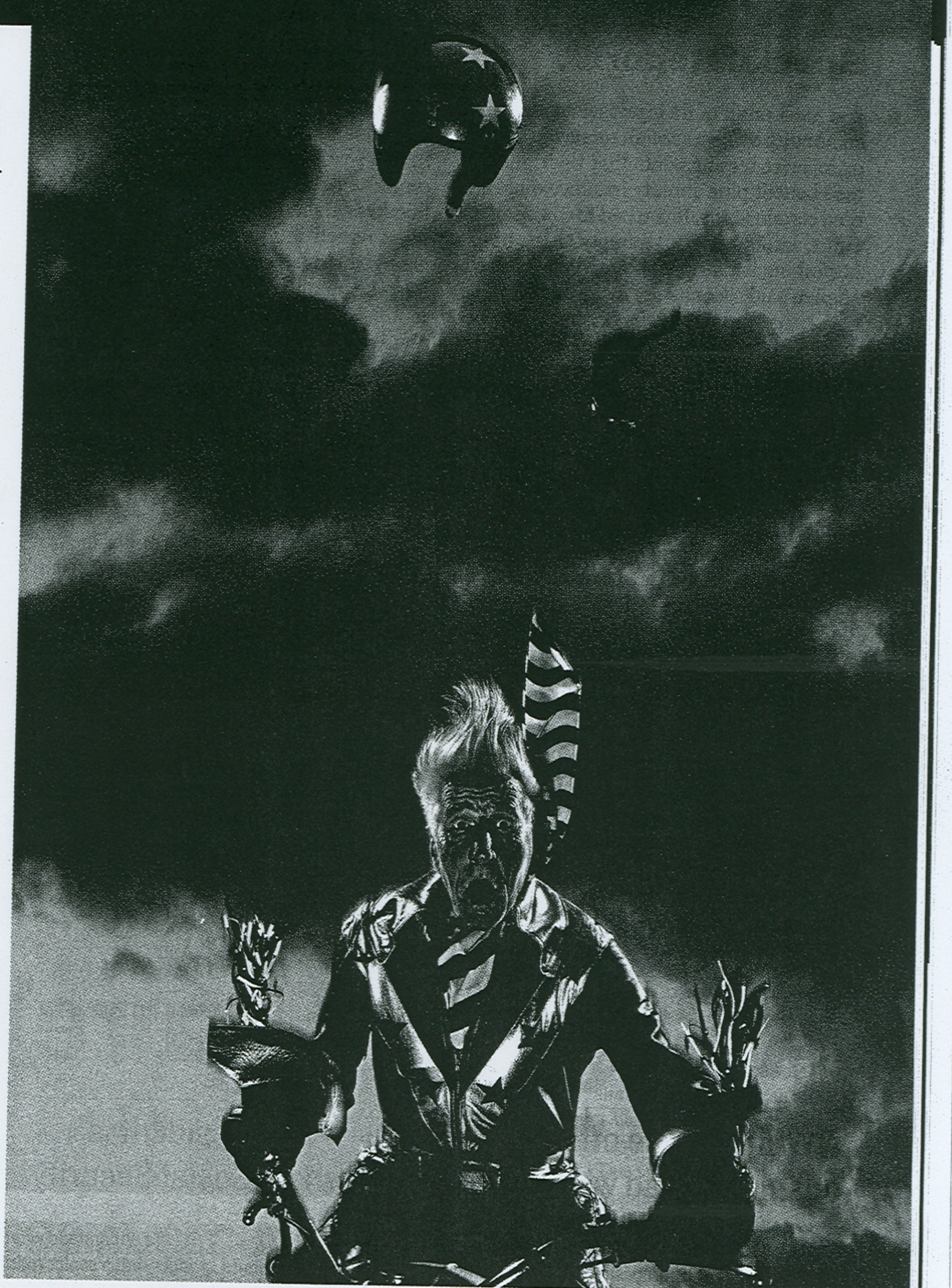
The average Social Security **lifetime benefit** for a two-earner (avg/low wage) couple is **$330,000**

SOURCES: EMPLOYEE BENEFIT RESEARCH INSTITUTE, SOCIAL SECURITY ADMINISTRATION, THE URBAN INSTITUTE, U.S. CENSUS called them savings. When you needed cash, you'd reach into the can, but all you'd find are IOUs. You'd have to bring in more money or spend less or borrow—just as if there were nothing in the can but coffee.

OK, LET'S FAST-FORWARD to 2018, when Social Security is projected to take in $23 billion less cash than it spends. By then, the trust fund would have more than $5 trillion of Treasury IOUs in it. So it would be a piece of cake to cover a crummy $23 billion, right? Wrong. No matter how many Treasury securities the trust fund has, Treasury would still need $23 billion of cash to cover Social Security's bills. The Treasury can trim other expenses, bring in more money or borrow 23 billion bucks. But these options are exactly the same as they'd be if there were no Social Security trust fund. By 2027, Social Security would be taking in almost $400 billion less than it spends, requiring huge cash influxes. The trust fund—on paper—would still be getting bigger. In the real world, though, Social Security's cash deficit would be seriously squeezing the rest of the government. Finally, as the cash deficit nears half a trillion dollars annually, the trust fund starts to shrink, then melts away. But the fund's irrelevant, folks. It's an accounting entry, not real money. How the Democrats can cling to the trust fund with a straight face is beyond me. Maybe it's because they don't want to shatter Social Security's myths, or let people see how expensive Social Security really is.

Now, look. These numbers show there's a problem if something doesn't change. But it's no crisis. If you want a crisis, look at the totally unfunded Medicare prescription-drug program that Bush shoved down Congress's throat in 2003. The same people who calculate that Social Security has a $10.4 trillion shortfall place the drug program's at $17 trillion. Social Security can cover its own expenses for a dozen years. The drug program—which isn't even good insurance, being riddled with coverage holes and assorted problems—starts chewing through money next year. Which is the bigger problem? Hint: not Social Security.

Now it's time to look at how Bush's private Social Security accounts would work. And who'd win and lose. Under Plan 2 in its current incarnation, you'd almost certainly want to sign up for these accounts if you're younger than 55. Yes, you'd have to accept a smaller guaranteed benefit. But you'd come out ahead if your account produced an annual return—cash income and price gains—of more than 3 percent above inflation. That's not a slam-dunk, but it ought to be



BUSH IS LIKE A CANDYMAKER THAT CUTS 46 PERCENT OFF A CHOCOLATE BAR BUT KEEPS CHARGING THE SAME 75 CENTS FOR IT. IT'S EFFECTIVELY A TAX INCREASE.

attainable because you would have a choice among a handful of high-grade, very-low-cost, very diversified mutual funds. But there's a catch. You would own the account, sort of, but you wouldn't control it. And you'd have to fork over the aforementioned 3 percent return—by taking a smaller benefit—when you cash in your account.

Bush, brilliantly, is marketing these accounts as empowering people who'd have no other assets. But I don't think things would work out well for these folks. There would be strict limitations on the accounts—you couldn't take money out of them before you retire, or even borrow against them. And the odds of a low-income person's being able to leave a significant account to her heirs—one of Bush's major selling points—strike me as remote.

Here's why. When it's retirement time, low-income people would likely have to convert most or all of their private account into an annuity to have enough money to live on, or to meet requirements that their guaranteed benefit plus annuity income would exceed certain levels. If you had to convert your entire account into an annuity, there would be nothing left for your heirs when you died. Higher-paid people, by definition, would have bigger private Social Security accounts and less need for annuity income than lower-income people would. This gives them a far greater chance of having something left to hand down to their heirs, and gives lower-paid people less chance. Not to be snotty, but we higher-income types hardly need additional breaks. We've already got plenty.

Staying power matters big time, too—and higher-income people have more of it than lower-income people do. Although stocks tend to rise over the long term, you'd have to cash in some or all of your retirement account to buy an annuity when you retire. That puts you at the mercy of events. Consider the following, produced at my request by the Center on Budget and Policy Priorities. Say you retired in March of 2000, with a private account that held $100,000 of stock in an S&P 500 Index fund. (Index funds match the performance of a benchmark; they don't try to beat the market.) Your inflation-adjusted annuity would have been $7,558 a year—about $630 a month—by the center's calculation. But if you had the same number of shares in your account and instead retired in October of 2002, your account would have had less than $60,000 in it. Your annuity: $3,352 a year, or $279 a month. The combination of lower values and lower interest rates is a double whammy. You see the problem? You can get much less—or much more—than someone who's saved at the same rate as you, but retired a little earlier or later.

IF YOU'VE GOT FINANCIAL STAYING power, you could wait for better days, or buy the smallest annuity the government will permit. If you don't have staying power, you have to take what the market gives you. Higher-paid people thus have a big advantage. The guaranteed Social Security benefit, by contrast, is tilted toward lower-income people, with a benefit of about 56 percent of Social Security-covered wages for a minimum-wage earner, 30 percent for folks like me who've reached the Social Security maximum every year. You're swapping benefits skewed toward lower-income people for investment opportunities skewed toward higher-income people.

I'm in favor of private accounts constructed along the lines that Bush suggested. But the accounts ought to be in addition to the basic benefit, not as a replacement for about half of it. Democrats

President Bush's Goal 'A Brighter Future'

A White House official explains why the president is pushing ahead with his plan to overhaul Social Security.

BY ALLAN B. HUBBARD

Social Security is one of the magnificent governing achievements of the 20th century. Those of us in government have a moral obligation to preserve and strengthen it. In our time, there is a moral imperative to reform it. If we do not, as President Bush noted in his State of the Union address, our children will inherit a bankrupt system.

To understand why Social Security faces problems, one must understand how Social Security works. Social Security has never been a savings program. It is, in effect, a "pay as you go" system. Most of the Social Security taxes paid by current workers are used immediately to pay for benefits. Any remaining surplus is spent by the federal government on current programs. No money has ever been actually saved.

A pay-as-you-go system can work well when there are a large number of workers to support each retiree. But as Americans live longer lives, and spend more years collecting retirement benefits, there will be many more retirees to support. In 1950, there were 16 workers to support each person on Social Security. Today there are slightly more than 3 workers per beneficiary. By the time today's young workers retire, there will be only two workers to support each person on Social Security.

To understand what a pay-as-you-go system imposes on workers, consider that a senior retiring today after a career with average wage earnings receives a Social Security benefit of roughly $14,200. If there were 16 workers to support that retiree, each could pay less than $1,000 in taxes. If there are three workers, they would each have to pay about $4,700. But if there are only two workers, each would have to pay $7,100. Such spiraling burdens are why we must begin to change to a system based on savings.

The enormous baby-boom generation will begin hitting the retirement rolls in 2008, just three short years away. By 2018, the cost of paying Social Security benefits will be greater than the taxes the system collects. And these annual shortfalls will only grow larger with time. By 2027, the annual shortfall will be more than $200 billion. By 2033, more than $300 billion.

If we fail to act, then our only choices will be to raise taxes, cut benefits drastically or engage in massive borrowing. This is why President Bush believes that we must deal with the problem today. The promises being made to future beneficiaries are $10.4 trillion more than the system can afford to pay, according to the Social Security Trustees. And, every year that we wait will add $600 billion to the cost of the problem. Clearly, the time for action is now.

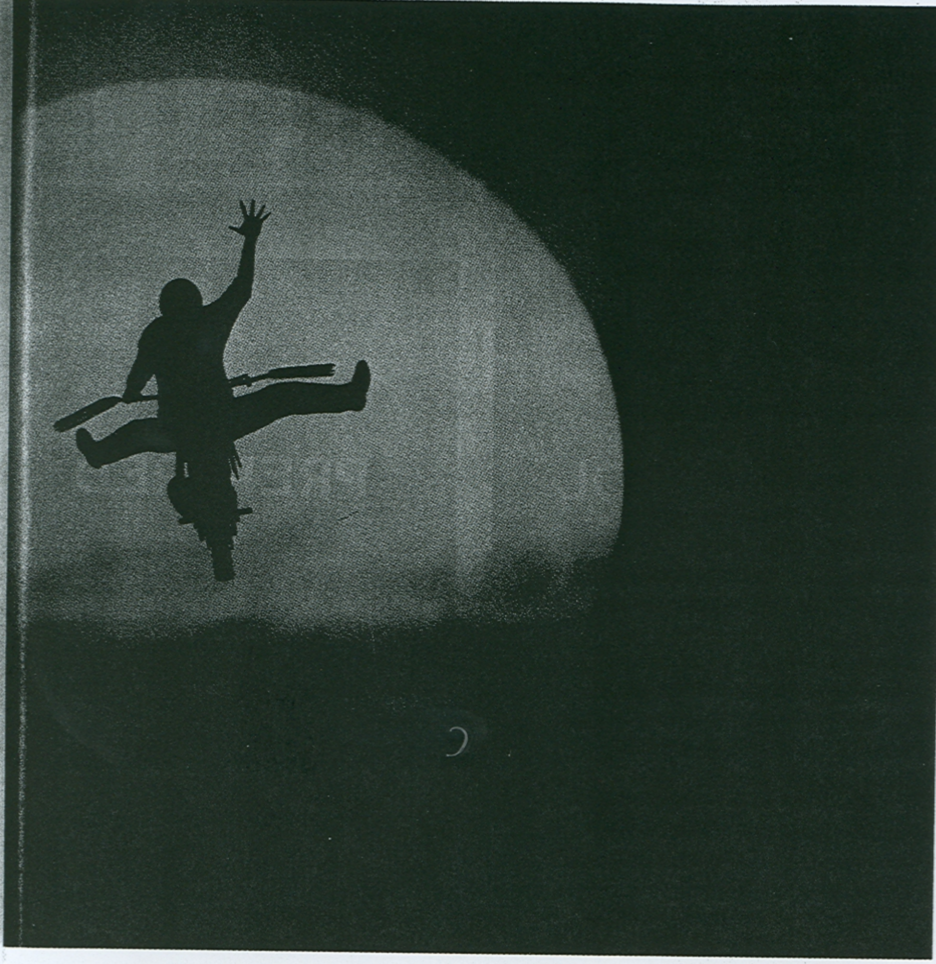
President Bush is committed to ensuring that there are no changes in benefits for those who were born before 1950—people who are 55 today.

are crazy to oppose private accounts. They really do empower you. The current generation is used to investing, and is understandably skeptical about government promises. This isn't the 1930s, when only a handful of people bought stocks, and many of them came to regret it. It's the oughts, guys, get with it. FDR's been dead for 60 years. The world has changed.

If the president really wants to fix Social Security rather than pick a political fight—and the Democrats feel the same—it wouldn't be difficult. They'd compromise by putting more money into the system by raising wage taxes a tad, taking less out by increasing the retirement age and trimming benefit formulas and setting up private accounts funded by wage earners, not by government borrowings. Put a few willing negotiators in a room and a deal's done in a month. I won't hold my breath, though.

Bush has marketed the pants off the Democrats by setting the terms of debate. Do you want to pay higher taxes or lower taxes? Clearly, lower. Do you want to pay estate tax or not? Do you want private accounts, or don't you? He's done a fabulous job of showing the goodies—and of hiding the costs. People, naturally, have opted for the goodies. The Bushies are in full sales mode, including sticking recordings on Social Security's phone lines preaching that the system has to change. In the name of empowering my kids, he's asking them to pay full freight for my retirement and for trillions in new borrowings, while forking over the same wage taxes for lower benefits. If he can sell this one, the Marketing Hall of Fame should start planning his induction ceremony. ■

LT Join Business Editor Adam Bryant for a Live Talk on retirement, Feb. 10 at noon, ET, on **Newsweek.com**



IF WE FAIL TO ACT ON SOCIAL SECURITY, THEN OUR ONLY CHOICES WILL BE TO RAISE TAXES, CUT BENEFITS DRASTICALLY OR ENGAGE IN MASSIVE BORROWING.

To fix the system for those under 55, he is willing to put all the options on the table—even politically difficult changes to Social Security's benefit structure. Many Americans are unaware that the current Social Security program is promising benefits to future retirees that are 40 percent higher than individuals are receiving today, even after adjusting for inflation, and 30 percent higher than the system can afford to pay. Something will have to be done, and the president has indicated his willingness to work with Congress to find the best way. The only option ruled out by the president is an increase in the payroll tax—because such an increase would be detrimental to workers, employers and to our economic growth.

The president also believes very strongly that those under 55 should have the voluntary opportunity to invest in a personal retirement account. This would give each worker the security of knowing that at least some of his or her payroll taxes are being saved. These accounts would offer younger workers the opportunity to receive a higher rate of return than they would receive under the current system. Workers would have true ownership of these accounts, and they could bequeath any unused balances to their families when they pass on.

Members of Congress, like employees of the Executive Branch, already know that personal accounts are a good idea. They have something similar, through a program that is available to federal employees. This system allows them to choose from a small number of safe, broadly diversified funds, which are administered at low costs and provide participants with the gains of long-term investing. President Bush wants American workers to have the same opportunity.

President Bush envisions accounts that are safe and secure, providing workers with protections, as well as the opportunity to receive the benefits of long-term investing. Workers would not be permitted to borrow from or against their accounts prior to retirement. Nor would they be permitted to withdraw all of the money at once, if doing so would leave them in poverty. Workers would have investment options that would minimize investment risks, especially near retirement age.

One of the hallmarks of the Bush presidency is his willingness to deal with big challenges. The president is tackling Social Security now not because it is easy; he's doing so because it is necessary. A complaint you often hear is that political leaders won't confront difficult tasks. President Bush is cut from a different cloth. He is willing to work with Congress to reform Social Security to save it and strengthen it—and in doing so together, we can leave a brighter future for our children and grandchildren.

ALLAN B. HUBBARD is assistant to the president for Economic Policy.

PHOTO ILLUSTRATION BY MICHAEL ELINS AND KEVIN HAND FOR NEWSWEEK, SUN PHOTO CORBIS